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TREASURY REGULATIONS.

Supreme Court of the United States

OCTOBER TERM, 1945.

No. 819.

CANADIAN RIVER GAS COMPANY,
Petitioner,

against

JOSEPH T. HIGGINS, formerly United States Collector of Internal Revenue for the Third District of New York,
Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

REPLY BRIEF FOR PETITIONER

1. Respondent's uniform characterization of the "advance royalties" as "bonuses" does not establish that such amounts are capital expenditures.

The principal basis for *respondent's* argument is the assumption that the cash payments made to the lessor when the leases were signed were "bonuses" and were not "advance royalties". The whole treatment of the payments by the Commissioner was as advance royalties and that is the status of such payments.

Respondent's brief carefully avoids the use of the term "advance royalties" and, without exception, refers to the payments made by the petitioner to the lessors as

"bonuses." The apparent purpose is to induce the Court to conclude that the payments are capital expenditures merely by calling them "bonuses." The court below first referred to the payments as "advance royalties, or so-called bonuses" and thereafter simply as "advance royalties" (R. 96-99). The stipulation of facts states: "Said items of 'bonus exhaustion' are more accurately designated as recoupment of advance royalties" (R. 29) and that the payments were "so-called bonuses, *i.e.*, cash payments made in connections with the acquisition of such leases" (R. 30). The Treasury Regulations (86 and 94) refer to "bonus or advanced royalty" (Art. 23(m)-10) and make certain provisions "if royalties in the form of bonus payments or advanced royalties* * * have been paid" (Art. 23(m)-1(g), Appendix to Petition, p. 26).

In *Herring* v. *Commissioner*, 293 U. S. 322 (1934), the Court refers to "advance royalty or bonus" (p. 323, 324). In *Douglas* v. *Commissioner*, 322 U. S. 275 (1944), the Court refers to "bonus or advanced royalties" (p. 280). In *Anderson* v. *Helvering*, 310 U. S. 404, 409 (1940), the Court said:

> "Cash bonus payments, when included in a royalty lease, are regarded as advance royalties, and are given the same tax consequences."

The facts as to the payments in question are undisputed. The parties enter into a gas lease. One provision of the lease is that the lessee must pay current royalties out of current production. Some leases, such as those here involved, also provide for a lump sum payment, which the lessor keeps whether or not there is production. The respondent's contention that this latter portion of the total amount payable by the lessee is a capital expenditure paid

for an economic depletable interest in the gas in place is not supported merely by referring to the payment as a "bonus".

As shown in our main brief, such payments have been held by this Court not to be payments for an interest in the property, but payments of advance royalties for gas to be removed in the future.

2. Respondent has failed to show how in the same transaction the lessee could acquire a depletable interest in the gas in place which the lessor did not transfer.

The basic contention of the *petitioner* is that the lump sum payment by the lessee under a royalty lease cannot be a capital investment in a depletable interest in the gas in place because the Supreme Court has held that in such a transaction the lessor does not transfer or part with any such interest. In response to this, respondent merely states the correct general principle "that a payment may represent the cost of a capital acquisition by the payor and still be ordinary income to the payee" (p. 7). That statement wholly fails to meet the point, as is conclusively demonstrated in the dissenting opinion below (R. 101). Respondent makes no effort to show how it is possible *in the same transaction* for one party to acquire an interest which the other party does not transfer. Nor does he make any effort to identify the property interest representing the alleged "capital investment."

The complete statement in *Burnet* v. *Harmel*, 287 U. S. 103, 112 (1932), of which respondent quotes a phrase, is:

> "Bonus and royalties are both consideration for the lease and are income of the lessor. We cannot say that such payments by the lessee to the lessor,

> to be retained by him regardless of the production of any oil or gas, are any more to be taxed as capital gains than royalties which are measured by the actual production."

This is the decision which holds that the lessor receiving advance royalties makes no sale of an interest in the property. Yet the Court is asked to refuse to review a holding that *in the same transaction and for the same payment* the lessee acquired from the lessor a depletable economic interest in the gas in place.

Of course, the lease as a whole and the payment of the current royalties and advance royalties required thereunder gave the lessee the "right to extract" gas from the property (*cf. Douglas* v. *Commissioner*, 322 U. S. 275). But that does not mean that either the advance royalties or the current royalties were a capital investment in the gas in place. Any such holding as to either type of royalties is impossible in view of the fact that the lessors are entitled to the depletion deduction (whether computed on the cost basis or the percentage basis) with respect to both current royalties and advance royalties, because the production attributable to these depletes the lessor's reserved interests in the gas in place.

If respondent fails in his contention that advance royalties are a capital investment by the lessee in the gas in place, the whole basis for the decision below collapses. If the lessee has not purchased the interest in the gas in place represented by advance royalties, such payment by the lessee must be, as the Supreme Court has said, "payment in advance for oil and gas to be extracted" (*Herring* v. *Commissioner*, 293 U. S. 322, 324 [1934]). The payment,

therefore, is part of the lessee's cost of gas produced from the lessor's reserved interest, which must be deducted from gross sales to determine the lessee's gain and gross income (Regulations, Art. 22(a)-5, Appendix to Petition, p. 26). No deduction from gross income is involved and no deduction for depletion is involved.

3. Respondent's contention that an allocable portion of the bonus must be excluded from the depletion base as "royalties" is irreconcilable with his contention that advance royalties are capital expenditures by the lessee.

On petitioner's alternative contention that it is entitled to a larger depletion deduction if the production allocable to advance royalties is production from a depletable interest in the gas in place which it has purchased, the respondent contends that Section 114(b)(3) requires the exclusion from the depletion basis of an "allocable portion of the bonus" (p. 7). This contention is that such amounts are "rents or royalties paid or incurred by the taxpayer in respect of the property." There is a direct and inherent conflict in holding that advance royalties are a capital investment in the gas in place for the purpose of treating as petitioner's gross income the production from this interest in the property and in the next breath holding that such payments are "royalties" under Section 114(b)(3). These two holdings are irreconcilable.

Petitioner's alternative contention does involve the allowance of percentage depletion both to the lessor and to the lessee with respect to the same gross income from the property. This results, however, only because respondent insists on treating these amounts as gross income of the

lessee as well as gross income of the lessor. If the same gross income from the gas property is to be taxed to different taxpayers, then, under the plain terms of the statute, both should be allowed depletion with respect thereto. But, if the depletion deduction cannot be allowed to both, the lessee's right to the deduction would seem to be superior to that of the lessor, if the lessee is to be treated as having purchased from the lessor the economic interest in the gas in place from which such production came.

Respectfully submitted,

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ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

MOTION FOR LEAVE TO FILE OUT OF TIME PETITION FOR REHEARING OF PETITION FOR WRIT OF CERTIORARI.

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